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Economics Department
McGraw-Hill Publications Company
1221 Avenue of the Americas
New York, New York 10020
Eric B. Weiss
Vice President, Economics

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15th ANNUAL McGRAW-HILL SURVEY OF CORPORATE PROFIT TRENDS

EXECUTIVE SUMMARY

American corporations expect 1980 domestic profits before income taxes to rise by 8.7%, according to the 15th Annual McGraw-Hill Survey of Corporate Profit Trends.

By contrast, profits in 1979 increased an estimated 14.2% over the previous year. After adjusting for inflation, real profits last year grew by an estimated 5.4%, while McGraw-Hill estimates that real profits this year will fall by about ½% when compared to 1979.

Among manufacturers, industries with the most optimistic pretax profits outlooks are aerospace and electrical machinery, with expected profits up 17.6% and 15.5% respectively. Meanwhile, declines in pretax profits are expected in five industries--iron and steel, nonferrous metals, autos, paper, and stone, clay, and glass.

For manufacturing as a whole, profits are expected to increase by 7%.

The nonmanufacturing sector is more optimistic, foreseeing a profits rise of 10.5% this year. No nonmanufacturing industry expects profits to decline in 1980.

The survey results also show that:

- Business expects cash flow this year to increase by 8%, down from an estimated 16% rise in 1979.

- More firms expect profit margins in 1980 to decline than to rise.

- Compared to 1979, firms this year will be seeking more external funds to finance capital projects.

- Nearly one-half of survey respondents expect banks to be the main source of external funds this year. Just 2% of firms expect new stock offerings to be their main source of funds.

These results suggest that the debt markets will be under continued pressure in 1980, thereby helping to keep the cost of money at high levels.

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Eric B. Herr
Vice President, Economics

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American corporations expect 1980 to be a slow-growth year for profits.

Based on responses from nearly 500 companies to the 15th Annual McGraw-Hill Survey of Corporate Profit Trends, domestic profits before income taxes for all U.S. business are projected to rise by just 8.7% in 1980. That projection represents the most pessimistic corporate outlook on profits since 1975, when respondents to the McGraw-Hill survey expected only a 5% increase in pretax profits. (As it turned out, profits actually declined in 1975.)

Moreover, since the 1980 inflation rate will likely exceed 8.7%, it appears that "real" corporate profits will decline this year. Using the broadest gauge of inflation--the gross national product (GNP) implicit price deflator--and assuming that respondents' expectations are met, McGraw-Hill estimates that real profits this year will fall by about ½%.

By contrast, pretax profits grew by an estimated 14.2% in 1979, which coupled with an 8.8% rise in the GNP price deflator resulted in a 5.4% advance in real profits. Of course last year's profits gains, due more to price rather than volume increases, were ballooned by the big petroleum industry results. Excluding petroleum, domestic pretax profits of U.S. business grew by 11.1% in 1979--a real increase of 2.3%.

In sum, the survey suggests that U.S. corporate profits this year will increase at a much lower rate than they did in 1979, and that the profits companies do make will have less purchasing power than they did last year. If the fourth quarter of 1979 rather than the whole of 1979 is taken as a base of comparison, it appears that profits in 1980 will essentially be flat if the survey projections are realized.

The profits picture this year could be worse, however, than the survey indicates. The reason is that survey repondents in the past have tended to be overly optimistic in recessionary times. Thus, if the long-awaited recession finally materializes this year, and if the survey's cyclical bias is repeated, the survey results will far exceed actual performance.

To take the recession year of 1970 as an example, respondents then said they expected pretax profits to rise by 6%. In fact, profits dropped a precipitous 16% in 1970, as real GNP slipped 0.3% below 1969.

One note should be injected here which may help explain the pattern of past survey results. The survey sample is skewed toward large companies. The survey results--which are extended to cover entire industries (not just large companies in those industries)--reflect that fact.

If large companies perform better during economic downturns than do small firms, as was the case in the past two recessions, the survey results would therefore be biased upward in such an environment.

The Sectors: A Mixed Bag

The aggregate expected gain in pretax profits of 8.7% naturally masks differences between the manufacturing and nonmanufacturing sectors, and the even sharper differences between individual industries.

While neither the manufacturing nor nonmanufacturing sectors is expecting a very robust year, nonmanufacturers are the more optimistic.

They look for profits to advance by 10.5% in 1980 compared to the manufacturers' expectations of a 7% rise.

The mining industry is expected to lead nonmanufacturers by posting a 13.2% gain in pretax profits this year. That gain comes on top of a 50% profits increase in 1979, although the comparison is distorted by the fact that a major coal strike affected mining operations in 1978.

Railroad profits in 1979, boosted by record freight traffic and a 12% freight rate hike, soared by an estimated 97%. Railroads expect profits this year to grow at the relatively good pace of 12%.

Nonmanufacturers with the most pessimistic view of 1980 profits are gas utilities and airlines.

If nonmanfacturers as a whole do manage to increase their profits by 10.5% this year, real profits will likely inch ahead to an historic high, as can be seen in the diagram on page 10, where profits have been deflated by the GNP implicit price deflator.

Among manufacturing firms, both durable and nondurable goods producers anticipate what should turn out to be a fall in real profits this year. Nondurables manufacturers are the less pessimistic of the two sectors, foreseeing a profits rise of 8.5% in 1980. Durable goods makers think profits will edge forward by just 5.5%.

The aggregates, however, hide differences among industries. The contrasts are sharpest within the durables sector, where profits in four industries are expected to decline. The severest setbacks are projected in autos and nonferrous metals, where pretax profits are seen dropping by 30% and 18% respectively. Nonferrous metals companies, though, are coming

off a strong 1979, when profits jumped by 46% over 1978.

The autos story is much different. Instead of 1979 being a big year, profits then were off 31% from the previous year. With gasoline prices well beyond the $1.00 mark and imports filling much of America's appetite for fuel-efficient vehicles, the plot is not expected to change substantially in 1980.

Steel is the only other industry expected to suffer its second straight year of profits declines. The steel slump, of course, is in part tied to malaise in the auto industry, but it is also linked to a slowdown in nonresidential construction (structural steel) and a sharp drop in housing starts (implying a cutback in purchases of appliances made with steel).

The fourth durables goods industry expecting a decline in 1980 profits is stone, clay, and glass, which also depends in part on motor vehicles and construction.

Despite expected profits decline in four industries, the durables sector as a whole is expected to turn in a plus performance in 1980 because of relatively strong projected performances of two big industries--electrical machinery (profits up 15.5%) and nonelectrical machinery (up 11.9%). Together, electrical and nonelectrical machinery makers will account for nearly half of all pretax profits of durable goods industries in 1980, if expectations are met.

The strongest performer among the durables, however, is expected to be aerospace, which possibly reflects some anticipation of increased defense spending.

Within the nondurables sector, one industry--paper--expects a small decline in pretax profits this year, while textiles firms foresee a

profits gain of just 1%. The big story, though, is the distinct falloff in profits gains expected by the petroleum industry. After watching domestic profits surge by 55% in 1979, petroleum firms look for only a 6% advance this year. The relatively low 1980 figure appears less surprising, though, when it is viewed in light of a windfall profits tax and a slackening demand for petroleum products. Moreover, it is interesting to recall that the U.S. profits of American petroleum companies zoomed up by 96% in 1974, only to fall by 19% the following year.

The Link to Capital Spending

Profits are of course a key indicator of an industry's general health. More particularly, profits point to an industry's ability to expand. Extra funds can be used to expand output immediately by hiring more people, or they can be used to expand future output via increased research and development expenditures.

One of the most important contributions profits make to expanded output is as a source of funds to finance purchases of machinery and equipment. While funds for capital expenditures can be borrowed or raised in the credit and equity markets, profits (via retained earnings) are a preferred source of funds. Therefore, if an industry has earned good profits in a given year, its ability to finance capital projects is increased.

Economists do not consider profits the most important factor in determining future capital spending--sales expectations,which depend on recent sales experience, are considered most significant. But by looking at the diagrams on pages 10 and 11, it can be seen that there is a

relationship between profits and capital expenditures.

In all three diagrams, the profits numbers are one year behind the investment numbers. The graphs are plotted this way because profits generated in one year generally affect capital spending in the following year. Thus, the similar up-and-down movements of profits and spending can be readily seen by appropriately shifting the years on the diagrams.

At the same time, it can also be seen that the correlation between profits and spending is hardly perfect. For example, in 1969 and 1970 the two series move in opposite directions for nonmanufacturing industries. However, the relationship appears reliable enough to allow some general comments on the capital spending outlook for 1981. (What follows are judgments based on the survey, but not survey results themselves.)

First, capital spending by durable goods producers should be weak next year due to its dull profits outlook this year. If a recession develops in 1980, this conclusion would be strongly reinforced. The reason is that durables is usually the hardest hit sector in times of recession, and thus a weak 1980 would lead to restrained 1981 sales expectations and, consequently, relatively small capital expenditures for that year.

Capital spending in 1981 by nondurable goods makers should be somewhat stronger since their profits expectations are higher than are those of the durables sector. Also, since the performance of nondurables over the business cycle is less volatile, a recession this year would have a lesser effect on its plant and equipment expenditures next year.

Finally, if profits expectations are met, the nonmanufacturing sector will be in better shape to finance capital projects next year than either of the two manufacturing sectors.

At the same time, it should be noted that expected increases in nonmanufacturing and nondurables profits for 1980 are sharply below the 1979 gains, the implication being that capital spending increases in 1981 will be weaker than the 1980 advance.

A Squeeze on Financial Markets

Besides asking for profits expectations, the survey also asked for company outlooks on profit margins, cash flow, and internal and external financing. The broad picture painted by the responses is that more companies' profit margins will fall than will rise in 1980, cash flow will grow realtively slowly, and firms will look increasingly to external sources to finance capital projects.

More specifically, 42% of survey respondents expect profit margins to decline this year, while 37% think profit margins will improve. The remaining 21% look for no change in margins.

Cash flow of business in the aggregate is expected to grow by just 8% in 1980. That's roughly half the rate of cash flow growth in 1979, as indicated by the Federal Reserve Board's flow-of-funds accounts. (Cash flow in the survey is defined as addition to retained earnings plus depreciation allowances.)

If internal sources of funds this year are tight, as the survey suggests, firms with capital projects to finance will likely turn increasingly to outside sources. And, in fact, the survey indicates that they will: Last year, survey respondents said they expected to finance

74% of plant and equipment purchases with internal funds. This year, respondents foresee 69% of financing coming from internal sources.

As in the past, respondents say that banks will by far be their major source of external funds, with the bond market a distant second. Nearly half the companies will look to the banks for most of their financing while a fifth say they will turn to the bond market. Most of the remaining companies will use other debt instruments as their main sources of funds this year. Just 2% of respondents indicate they will offer new shares of stock to raise most of their monies. The proportion of firms saying they will look primarily to the stock market is the lowest since the question was first asked in 1972, when 5% indicated major reliance on new equity issues. Since then, excluding the current survey, the average proportion of firms indicating the stock market as their major source of financing has been nearly 10%.

In sum, the survey suggests a scenario this year in which corporations will try to maintain capital spending plans by seeking relatively more funds from outside sources, those sources being almost exclusively the debt markets.

The question which naturally follows is: Will sufficient funds be available, and if they are, at what price will they be available?

The question for large companies is probably one of price rather than availability, since they can generally obtain outside funds more easily than can smaller firms. (This belief is supported by a survey finding--contained in a separate report--that the Federal Reserve Board's credit-tightening policies announced last October 6 had the most effect on smaller companies' capital spending plans.)

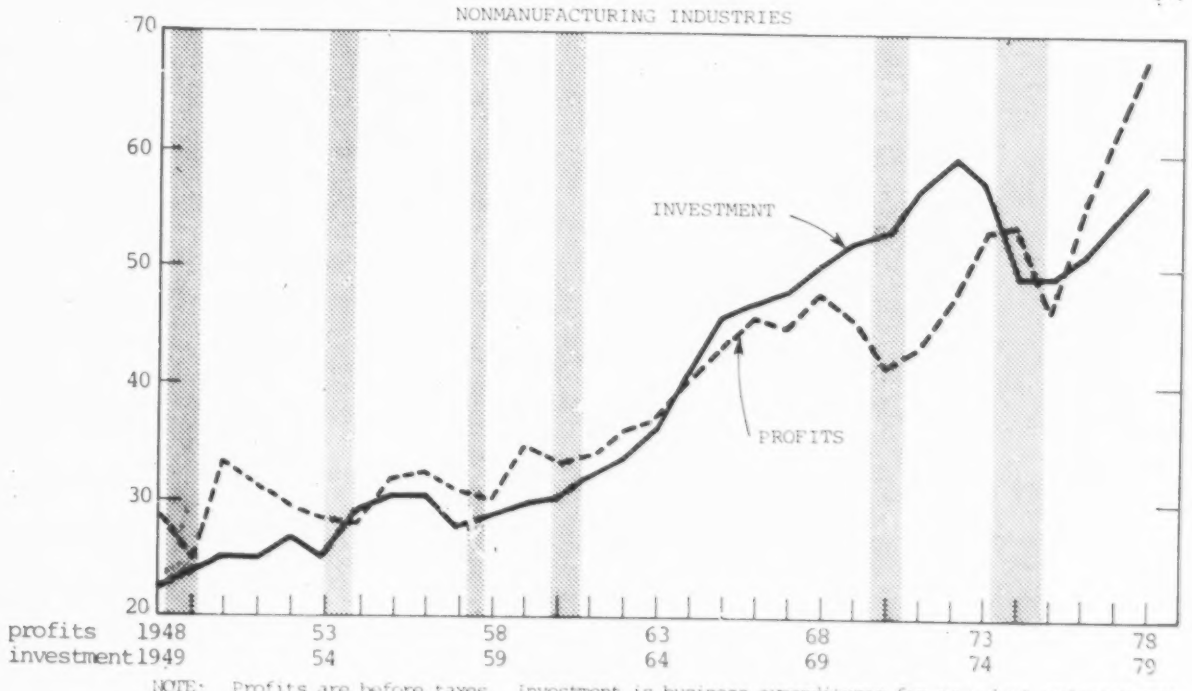
But if the Fed sticks to its guns in restricting the rate of money supply growth, thereby slowing the growth of loanable funds, smaller companies could be in a bind. Many in fact have already curtailed plans to buy plant and equipment this year, and many more may have to make that decision.

The Fed's anti-inflation fight of course also entails a high discount rate, and thus high interest rates in general. If in addition there is continued demand on banks and other debt sources, as the profits survey indicates, it almost assures that the cost of financing capital projects will remain high.

The Fed policy of eventually reducing interest rates by cutting the rate of inflation will, if followed, take a long time to work. So the only thing that could noticeably drag rates down this year is a recession. In other words, corporate borrowers are probably in for a difficult year: For some, funds may not be available at all. For others, the price will be high (at least in nominal terms). Alternatively, the price of external funds could fall, but only after a recession.

Notes on the Survey

The results in this report are based on a survey in which financial executives were asked to provide their firms' outlooks on profits, profit margins, cash flow and financing. The survey was conducted by the McGraw-Hill Publications Company's Department of Economics in January and February, and elicited responses from 481 companies. Using the outside sources referred to in Table I, the economics department estimated 1979 profits for each industry. Definitions and explanatory notes appear at the bottom of the tables. Firms in the sample are larger than industry averages, which may bias the results toward the trends of these larger firms.



NOTE: Profits are before taxes. Investment is business expenditures for new plant and equipment. Both profits and investment are in constant 1972 dollars. Shaded areas represent recessions.

SOURCE: Department of Commerce.